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In The

Supreme Court of the United States

October Term, 1981

CONTAINER CORPORATION OF AMERICA,

Appellant,

vs.

FRANCHISE TAX BOARD,

Appellee.

On Appeal From the Court of Appeal
of the State of California
for the First Appellate District

BRIEF FOR GULF OIL CORPORATION AS AMICUS CURIAE IN SUPPORT OF APPELLANT

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STATEMENT OF INTEREST

This Brief is submitted with the written consent of the parties on file with the Clerk of this Court.

Gulf Oil Corporation ("Gulf") and most of its subsidiaries are engaged in the petroleum business in the United States and other countries of the world. Its primary oil production has

been in Kuwait, Iran, Nigeria, Ecuador, Venezuela, and Angola. These countries are hereinafter referred to as the "KINEVA" countries (an acronym composed of the first letter of each name).

Because of the substantial effect of state income taxation upon its business activities, Gulf has a special interest in this case which presents issues significantly affecting state taxation of foreign commerce.

Gulf currently is challenging in several states at the administrative level the propriety of the formula apportionment method as applied on a worldwide basis. Gulf recently litigated the issue with respect to the years 1966-1974 in a California trial court.[1]

Under the combined report/formula apportionment method of income taxation (simplistically referred to by some commentators as the "unitary approach," "unitary apportionment approach," or by similar terms), Gulf's state income tax liability is determined by combining the worldwide income (without deducting domestic or foreign income taxes) of Gulf and its worldwide subsidiaries, which income then is attributed to a particular state under the so-called "three-factor formula" apportionment method, *i.e.*, on the basis of the relative amounts of property, payroll, and sales in the state, as compared to the total worldwide property, payroll, and sales of the combined group.

Gulf is not contesting the propriety of the combined report/formula apportionment method as applied to income from operations conducted within the United States. However, it does contend that the determination of the amount of income earned from operations within the United States should be made under the internationally accepted arm's length method.

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[1] *Gulf Oil Corporation, et al. v. The Franchise Tax Board of the State of California,* Superior Court of the State of California for the County of San Diego, No. 414285. The case, which also involved other issues, was favorably settled to Gulf near the conclusion of Gulf's case in chief.

The determination of what constitutes foreign income should be made in the same way. The concept of applying the combined report/formula apportionment method to income from operations conducted within the boundaries of the United States (*i.e.*, the "water's edge"), but applying the arm's length method to determine that amount of the United States income, is commonly referred to as the "water's edge" rule.

Gulf's concern here is to alert this Court to the overwhelming disparity between economic and taxing conditions in other countries of the world, such as in the KINEVA countries, as compared to those in the United States, and thus to demonstrate the inequity resulting from the application, by the State of California or any other state, of the combined report/formula apportionment method to income from operations beyond the "water's edge."

SUMMARY OF ARGUMENT

The combined report/formula apportionment method of income taxation originated as a judicially created concept which was borrowed from property tax cases as an expedient, albeit rough, method of dividing profits among the various states of the United States. It has been developed and nurtured in the context of operations within the United States, where such things as productivity, investment costs, payroll costs, risk factors, and taxing patterns are reasonably comparable, and where currency values are the same.

Fundamental to the rationale of the method is the assumption that all states within the United States are reasonably homogeneous in terms of economic and taxing conditions. On a worldwide basis, a similar assumption is simply not true, and the method thereby becomes inequitable and distortive when extended to the nonhomogeneous world. Generally, the formula apportionment method has been applied throughout the years to single enterprises only. A few states, such as California and Illinois, are now attempting to apply the method on a combined basis to multiple enterprises.

The great differences between the economic and taxing conditions in other parts of the world as compared to those in the United States are vividly demonstrated by the following facts, which reflect comparisons between the KINEVA countries and California in the years 1971-1974:[2]

(1) Payroll costs in California per dollar of oil output were from 15 to 40 times higher than the comparable costs in the KINEVA countries.

(2) Property costs in California per dollar of oil output were from 16 to 30 times higher than the comparable costs in the KINEVA countries.

(3) Average daily output per oil well in the KINEVA countries ranged from 294 to 358 times that in California.

(4) Income tax rates in the KINEVA countries, when considered under California concepts of taxable income, ranged from 96% to 107% (as compared to the United States rate approximating 48%).

(5) The excess of income taxes paid to the KINEVA countries over what the Gulf group would have paid had the same income been earned in the United States ranged from $697 million to $2.488 billion per year.

In *Japan Line, Ltd. v. County of Los Angeles,* 441 U.S. 434 (1979), this Court determined that, when testing a tax under the Foreign Commerce Clause of the United States Constitution (Article I, Section 8, Clause 3), two requirements must be met, over and above those applicable under the Interstate Commerce Clause. First, the tax must not create a "substantial risk of international multiple taxation," and, second, the tax cannot prevent the Federal government from "speaking with one voice when regulating commercial relations with foreign governments."

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[2] The facts set forth herein are based upon the evidence introduced by Gulf in the California litigation referred to in fn. 1. The years 1971-1974 were the last four years involved in that litigation.

Both of these requirements would be violated if a state were permitted to extend the combined report/formula apportionment method to foreign operations of multinational enterprises, whether they be foreign or domestically owned. Foreign commerce is preeminently a matter of national concern. In such matters, the Government must speak with one voice, and notwithstanding apportionment the tax must not create a substantial risk of international multiple taxation.

Most of the non-Communist major countries of the world, including the United States, have entered into an extensive network of treaties covering the avoidance of double taxation of income, and the touchstone of taxation under all of these treaties is the arm's length method, *viz.*, the "water's edge" rule.

To the extent that any state within the United States applies the combined report/formula apportionment method on a worldwide basis, it attributes to that state a certain portion of income which has already been taxed under the internationally accepted arm's length method by a foreign country, *e.g.*, each of the KINEVA countries. Since the foreign country has already taxed 100% of that income, the imposition by a state of a tax on a portion of that same income subjects that income to double taxation.

Obviously, since the foreign country uses arm's length principles, no correlative adjustments will be made by the foreign country by reason of the attribution of income to the state imposing the combined report/formula apportionment method, and the United States courts have no power to relieve that inequity. Under such circumstances, multiple taxation inevitably results.

The problem of double taxation becomes particularly acute by reason of the fact that economic and taxing conditions throughout the world are substantially disparate from those existing in the United States. No formula method could possibly be workable unless an authoritative tribunal existed to remedy multiple or unjust taxation.

ARGUMENT

I

The Rationale Of Combined Report/Formula Apportionment Does Not Apply To Foreign Operations Of Multinational Enterprises.

The concept of formula apportionment originated as a judicially created concept which was borrowed from the property tax cases as an expedient, albeit rough, method of dividing the total profits of an enterprise, for income tax purposes, among the various states in which the enterprise operates.[3] A primary element in the development of formula apportionment within the United States has been a quest for uniformity and comity among the states, rather than mathematical precision.[4] The rationale of formula apportionment is that each dollar of property, payroll, and sales produces an equal amount of income. Obviously, this rationale assumes at least roughly comparable economic and taxing conditions in the various taxing jurisdictions. While such comparability may reasonably exist among the states of the United States, it does not exist on a

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[3] *See, e.g., Adams Exp. Co. v. Ohio State Auditor,* 166 U.S. 185 (1897). *Underwood Typewriter Co. v. Chamberlain,* 254 U.S. 113 (1920); *Butler Bros. v. McColgan,* 315 U.S. 501 (1941).

[4] This was early recognized by Professor T. S. Adams of Yale, one of the early pioneers on the subject, who declared in 1917 to the National Tax Association:

> "What is most needed is a uniform rule. Just what rule shall be selected is less important than the general adoption of the same rule by competing jurisdictions."

1917 Nat. Tax Ass'n. Proceedings 185, at 194. A Committee of the National Tax Association, echoing Dr. Adams' views, put the matter thus in 1922:

> "All methods of apportionment of trading profits are arbitrary. . . . [T]here is no one right rule of apportionment. . .[T]he only right rule . . . is a rule on which the several states can and will get together as a matter of comity."

"Report of Committee on the Apportionment between States of Taxes on Mercantile and Manufacturing Business," 1922 Nat. Tax Ass'n. Proceedings 198, at 201.

worldwide basis,[5] as shown by the actual facts of the Gulf group. Therefore, the basic assumption underlying the combined report/formula apportionment method; namely, that each dollar of payroll or property, as the case may be, produces a roughly equivalent amount of income in each of the jurisdictions in which a taxpayer operates, becomes fallacious when applied on a worldwide basis.

The tremendous disparities between economic and taxing conditions elsewhere in the world, such as in the KINEVA countries, and those in the United States, are vividly demonstrated by the following Gulf facts, based upon the years 1971 through 1974:[6]

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[5] In addition, formula apportionment mechanically divides overall profits based on deemed economic activity without regard to the realities of the marketplace. The arm's length method tracks the marketplace where profits or losses do not conform to a simplistic formula, and market conditions are substantially more diverse on a worldwide basis than within the United States. See, Surrey, "Reflections on the Allocation of Income and Expenses Among National Tax Jurisdictions," 10 Law and Policy in International Business, 409, 415 (1978) (The International Journal of Georgetown University Law Center).

[6] See fn. 2.

A. Economic Disparities

1. *Productivity Per Dollar of Payroll*

Table 1 below shows the differences in payroll costs per dollar of output in California as compared to the KINEVA countries:

Table 1

Payroll Cost Per $ of Output 1971-1974

	(1) California	(2) KINEVA	(3) Ratio of (1) to (2)
1974	$ .122	$ .003	40:1
1973	.252	.012	21:1
1972	.276	.018	15:1
1971	.255	.016	16:1

Thus, a dollar of payroll in the KINEVA countries produced from 15 to 40 times as much revenue as a dollar of payroll in California.

2. *Productivity Per Dollar of Property*

Table 2 shows the differences in property costs per dollar of output in California as compared to the KINEVA countries:

Table 2

Property Cost Per $ of Output 1971-1974

	(1) California	(2) KINEVA	(3) Ratio of (1) to (2)
1974	$ 4.683	$ .150	31:1
1973	11.843	.435	27:1
1972	12.028	.725	16:1
1971	11.219	.708	16:1

Accordingly, a dollar of property in the KINEVA countries produced from 16 to 31 times as much revenue as a dollar of property in California.

3. *Productivity Per Oil Well*

Table 3 below shows the differences between California and the KINEVA countries in average daily output per oil well:

Table 3

Average Daily Output Per Well (barrels per day) 1971-1974

	(1) California	(2) KINEVA	(3) Ratio of (1) to (2)
1974	22	7880	1:358
1973	21	7510	1:357
1972	24	7430	1:309
1971	24	7070	1:294

It is apparent from the above figures that the basic economic conditions in the KINEVA countries are dramatically different from those in California. An oil well in the KINEVA countries was about 300 times as productive as an oil well in California.

B. Disparity in Taxing Conditions

Table 4 below shows the KINEVA income tax burden imposed upon the Gulf group based upon KINEVA pre-tax income (calculated in the same manner as California computes taxable income):

Table 4

KINEVA Income Tax Burden
1971-1974
($ in Millions)

	(1) KINEVA Pre-Tax Income California Basis	(2) KINEVA Income Taxes	(3) Income After KINEVA Taxes	(4) KINEVA Tax Rate
1974	$2,317.7	$2,488.1	$(170.4)	107%
1973	1,322.8	1,283.7	49.1	96%
1972	781.9	774.2	7.7	99%
1971	732.3	714.1	18.2	97%

The effective KINEVA tax rates, based upon California concepts of taxable income, ranged from 96% to 107%. Yet, California imposed its tax upon the pre-tax income shown in Column (1) of Table 4 by application of the combined report/formula apportionment method. California allowed neither a credit nor a deduction for these foreign income taxes shown above.

Had the KINEVA operations of the Gulf group been conducted in the United States rather than in KINEVA, the income tax burden, to yield the same amount of after-tax income to the Gulf group, would have been dramatically less, as demonstrated in Table 5 below.

Table 5

KINEVA Income Tax Burden
As Contrasted to
Comparable U.S. Income Tax Burden
1971-1974
($ in Millions)

	(1) KINEVA Income Taxes	(2) Comparable U.S. Income Tax Burden[7]	(3) Excess of (1) over (2)
1974	$2,488.1	$ -0-	$2,488.1
1973	1,283.7	45.3	1,238.4
1972	744.2	7.1	767.1
1971	714.1	16.8	697.3

The Gulf group's KINEVA income taxes exceeded the taxes which would have been paid to the United States, had that income been earned in the United States, by amounts ranging from $697 million to $2.488 billion per year. Thus, the income taken into account by California in applying the combined report/formula apportionment method is overstated by the same excess amounts shown in column (3) of Table 5. This obviously penalizes the Gulf group for operating in KINEVA rather than in the United States.

A corporation operating in California or elsewhere in the United States would have paid a Federal income tax in the range of 48%, leaving it with 52% of each dollar of taxable income in its pocket. In the KINEVA countries, however, the Gulf group paid income taxes (under California concepts of taxable income) at effective rates ranging upward from 96%, thus leaving it with 4% or less of each dollar of taxable income in its pocket. In the case of the Gulf group these excess taxes were enormous, *i.e.*, up to $2.488 billion per year. California imposed its tax on its attributed share of these excess taxes.

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[7] Derived by "grossing up" the KINEVA after-tax income shown in column (3) of Table 4 to what would be the U.S. pre-tax income required to produce such after-tax income. The income shown in said column (3) is divided by the assumed U.S. after-tax income, *i.e.*, 52% (based upon an assumed tax rate of 48%), to arrive at said "grossed-up" income.

The inequity of the combined report/formula apportionment method under these diverse world taxing conditions is obvious. While, companies operating within the United States incur the same level of Federal taxation, the Gulf group, because it operated in the KINEVA countries, was taxed by California on a much higher level of taxable income.

As is apparent from the above comparisons between economic and taxing conditions in the KINEVA countries and those in California, the combined report/formula apportionment method is ill-adapted for worldwide use. The formula apportionment method was developed and has been nurtured in the context of operations within the United States where such things as productivity, investment costs, payroll costs, risk factors, and taxing patterns are reasonably homogeneous, and where the currency is the same. On a worldwide basis, however, the rationale of formula apportionment becomes inapplicable.

There are wide ranges in wage rates and productivity of labor in different areas of the world; substantial differences exist in costs and productivity of plant, equipment, and other property; risk factors and rates of return are different, currencies are different, and conversion rates fluctuate. Taxing patterns also differ, and, as pointed out, California and many other states give neither a credit nor a deduction for foreign income taxes. This distorts the product of the formula apportionment method because the income base against which the formula is measured is not comparable to a base derived from United States operations.

World conditions simply are far more diverse than conditions in the states of the United States, and these differences are much too common and far too significant and complex to be accommodated on some *ad hoc* basis by modification of an apportionment formula. The formula method is intended as a rule of virtually universal application, and it simply becomes irrational and arbitrary in the worldwide context. Whatever the shortcomings of the arm's length method may be, they surely

are not sufficient to warrant the imposition of the formula method which has lost its rational underpinnings in the context of diverse world conditions.

II

This Court's Holding in *Japan Line, Ltd.* Prohibits State Taxation of Foreign Commerce When It Prevents the Federal Government From Speaking with "One Voice" or Creates a Risk of Multiple Taxation.

In *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979), this Court set forth the governing principles which apply when testing a tax on instrumentalities of foreign commerce under the Foreign Commerce Clause, which are over and above those applicable under the Interstate Commerce Clause. First, the tax must not create a "substantial risk of international multiple taxation."[8] Second, the tax cannot prevent the Federal government from "speaking with one voice when regulating commercial relations with foreign governments."[9] "If a state tax contravenes either of these precepts, it is unconstitutional under the Commerce Clause."[10]

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[8] 441 U.S. at 451.

[9] *Id.*

[10] *Id.* Although this Court declined to apply the *Japan Line* rationale in *Mobil Oil Corp. v. Commissioner*, 445 U.S. 425 (1980), which involved an income tax, the *Mobil* situation was correctly analyzed by this Court as involving only issues of interstate commerce, not foreign commerce, since Mobil conceded that the dividend income in question could be taxed by the State of New York. Moreover, *Mobil* involved only the issue of multiple taxation, and not the issue that the Nation must speak with "one voice."

This Court's decision in *Bass, Ratcliff & Gretton v. State Tax Commission*, 226 U.S. 271 (1924), which upheld formula apportionment (not combined reporting) as to a foreign corporation operating directly within the United States, involved, insofar as the Foreign Commerce Clause was concerned, only the limited issue of whether the tax constituted a direct tax on foreign commerce. Further, the record, both factually and legally, was so incomplete as to leave this Court with no logical basis for rejecting the formula concept. Moreover, international economic, trade, and tax relationships today can hardly be compared to those which existed in 1918 (the fiscal year in issue), over 60 years ago.

Both of the above precepts would be violated if a state were permitted to extend the combined report/formula apportionment to foreign income of multinational enterprises, *viz.*, beyond the "water's edge."

III

Multinational Trade Clearly Constitutes an Area in Which the Federal Government Must Speak With "One Voice" and in Which It Has So Spoken Through a Network of Tax Treaties.

"Foreign commerce is preeminently a matter of national concern,"[11] and the Federal Government must speak with "one voice." Multinational trade must be governed by internationally accepted principles of taxation, not by peculiar taxing concepts of individual nations, and certainly not by those of states or other political subdivisions of nations. There is no question but that the "arm's length" method, not formula apportionment, is the internationally accepted rule for the taxation of multinational trade. The United States and most of the major non-Communist countries of the world have established tax principles which govern multinational trade relationships through an extensive network of tax treaties. These tax treaties universally embrace the "arm's length" method to separate foreign income from United States income. The concept of formula apportionment is prohibited under these treaties with respect to transactions between treaty nationals. Formula apportionment is thus prohibited beyond the territorial boundaries of the United States, *viz.*, the "water's edge" rule.[12]

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[11] *Ibid.*, fn. 8, at 448.

[12] See, Staff Policy Report of the Advisory Commission on Intergovernmental Relations, published as a separate report entitled "State Taxation of Multinational and Multistate Corporations" (9/4/81), at p. 9.

The Advisory Commission on Intergovernmental Relations is the permanent commission established by Congress in 1959 to monitor intergovernmental relations and to make recommendations for change. Members include federal, state and local elected and appointed officials and private citizens.

(Footnote continued on following page)

Moreover, formula apportionment in multinational transactions has been repudiated by various world organizations, such as the Organization for Economic Co-operation and Development and the United Nations.[13]

The adverse reaction of foreign nations to the proposed application of the combined report/formula apportionment method to multinational operations of foreign-owned affiliated groups has been vehement. A number of foreign governments have lodged formal letters of protest with the United States Government.[14] While it is true that foreign governments are primarily concerned with groups owned by their own corporate nationals, the interpretation of the Foreign Commerce Clause should not depend upon whether the multinational group is foreign owned or domestically owned. It would be incongruous to construe the Foreign Commerce Clause so as to discriminate against domestically owned multinational groups by imposing the combined report/formula apportionment method on such domestic groups but not on foreign owned groups.

(Footnote continued from preceding page)

See also, Articles 7 and 9 of both the Organization for Economic Co-operation and Development Model Convention for the Avoidance of Double Taxation With Respect to Taxes on Income and Capital (1977), and the United States Treasury Department's Model Income Tax Treaty of May 17, 1977, reprinted at 1 CCH, Tax Treaties, § 151, 153.

[13] Seventh Report, Report of the Group of Experts on Tax Treaties Between Developed and Developing Countries on the Work of Its Seventh Meeting, United Nations, Department of Economic and Social Affairs, "Tax Treaties Between Developed and Developing Countries" (1978), published by the United Nations as a separate report; Organization for Economic Co-operation and Development, Report of OECD Committee on Fiscal Affairs "Transfer Pricing in Multinational Enterprises" (1979).

[14] *Ibid.*, fn. 12, at 11.

IV

Worldwide Unitary Treatment Inevitably Results in Double Taxation.

There can be no doubt that the combined report/formula apportionment method, when applied on a worldwide basis, creates more than the risk of multiple taxation; it produces multiple taxation in fact. All of the income earned abroad is taxed under internationally accepted arm's length principles, without any apportionment. To the extent that any state utilizes worldwide combined report/formula apportionment, it attributes to that state a certain portion, as determined by the formula, of the income which has already been taxed 100% by a foreign country. Thus, the taxation by a state of a portion of that same income in fact imposes an impermissible multiple tax burden on that income.

Obviously, since the foreign country uses arm's length principles, no correlative adjustments will be made by the foreign country by reason of the attribution of income to the state imposing the combined report/formula apportionment method, and the United States courts have no power to relieve that inequity. Under such circumstances, "multiple taxation inevitably results."[15]

If all the states had approximately equal tax rates and applied the formula method uniformly (which they do not), proper tax harmonization would occur in the case of a taxpayer operating wholly within the United States, inasmuch as that taxpayer would be taxed only once at the state level (and only once at the Federal level). On a worldwide basis no such harmonization is possible.

It is no answer to say that no double taxation occurs because the United States Government allows a credit against Federal income taxes for foreign income taxes paid. In the first place, this credit is a feature of Federal tax policy to alleviate

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[15] *Ibid.*, fn. 8, at 447.

double taxation at the Federal level. It is not a license for states such as California to impose a double tax burden on multinational taxpayers at the expense of the Federal Government. Secondly, the amount of the Federal credit is limited to the rate of Federal taxation, computed on income determined under United States principles of taxation, and in the case of Gulf, for example, the foreign tax burdens in the KINEVA countries vastly exceeded the amount of tax credits available against United States income taxes.

It is also no answer to argue that there otherwise is no absolute symmetry between the taxing systems of the United States and those of many foreign countries, and thus there always may be some double taxation. The fact that tax symmetry is not otherwise perfect throughout the world does not justify the imposition by the State of California of an additional inequitable double tax burden on multinational taxpayers.

It is likewise invalid to argue that there is no double tax burden as to countries which levy taxes only at the national level rather than both at the national level and at the local level. Whether or not a particular country is structured with a type of political subdivision such as we have in the United States, and whether or not a particular country may choose to fund its governmental operations solely through national taxes rather than a combination of national and local taxes, is purely a function of the political infrastructure of the particular foreign country, and is irrelevant to the double taxation issue.

Moreover, even "[i]f the State imposes an apportioned tax, international disputes over reconciling apportionment formulae may arise," and "notwithstanding apportionment . . . [the tax must not create] a substantial risk of international multiple taxation."[16]

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[16] *Ibid.*, fn. 8, at 450-51.

"Due to the absence of an authoritative tribunal capable of ensuring that the aggregation of taxes is computed on no more than one full value, a state tax, even though 'fairly apportioned' to reflect an instrumentality's presence within the State, may subject foreign commerce 'to the risk of a double tax burden to which [domestic] commerce is not exposed, and which the commerce clause forbids.' "[17]

This necessity for an international "authoritative tribunal" is acute with respect to worldwide formula apportionment because of the tremendous disparity between economic and taxing conditions abroad and those in the United States, and international conformity on the issue of allocation of income is critical "if there is to be order and rationality in the tax relationships among nations."[18]

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[17] *Ibid.*, fn. 8, at 447-48, citing *Evco v. Jones*, 409 U.S. 91 (1972), at 94, quoting *J. D. Adams Mfg. Co.*, 304 U.S. 307 (1938), at 311.

[18] In any event, the formula apportionment method, "when applied to an enterprise touching two or more countries requires some international authority or arrangement to be operable, and hence at least on a short-range horizon does not seem feasible." Surrey, *op. cit.* fn. 5, at pp. 409, 416.

CONCLUSION

The combined report/formula method was created and has been nurtured in the United States, where the economic and commercial environment in the various states is reasonably comparable. World conditions can be tremendously disparate. The arm's length method is the touchstone of international tax relationships and harmonization, and double taxation would "inevitably result" if the formula concept were applied to income from foreign business operations. Accordingly, the combined report/formula method should not be extended beyond the "water's edge."

Respectfully submitted,

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